



BILL DRAFT 2007-SVxz-21: Close Franchise Tax Loopholes

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	Date:	April 30, 2008
Introduced by:		Summary by:	Cindy Avrette
Version:	Bill Draft		Committee Staff

SUMMARY: *This bill draft makes changes to the franchise tax laws that conform to changes the General Assembly made in 2006 and 2007 to the corporate income tax laws. The changes are recommended to the Revenue Laws Study Committee by the Department of Revenue. The bill would become effective for taxable years beginning on or after January 1, 2008.*

BILL ANALYSIS: The bill draft provides that LLCs that elect to be taxed as S corporations are subject to the franchise tax in the same manner as other S corporations and that captive REITs are subject to the franchise tax in the same manner as a corporation.

In 2006, the General Assembly amended the definition of 'corporation', as it applies to the franchise tax statutes, to include a limited liability company that elects to be taxed as a C corporation for federal income tax purposes. The Department began to receive questions from S corporations as to whether they could convert to an LLC and elect to be treated as S corporations for income tax purposes, thereby being exempt from paying franchise tax. In 2005, S corporations paid more than \$50 million in franchise tax. Section 1 of the bill draft provide that an LLC that elects to be treated as a corporation for income tax purposes, either a C corporation or a S corporation, is also considered a corporation for franchise tax purposes. Section 2 makes a conforming change to the definition of 'noncorporate limited liability company'.

In 2007, the General Assembly limited a corporation's ability to use captive real estate investment trusts (REITs) to avoid State taxes by disallowing the dividend paid deduction when a REIT is a captive REIT. The effect of this change is that a captive REIT is treated as a regular corporation for income tax purposes. A REIT is an organization that uses the pooled capital of many investors to purchase and manage real estate.¹ A REIT that is owned or controlled by a single entity is commonly referred to as a captive REIT.²

Section 3 of the bill draft would provide that a captive REIT is also treated as a regular corporation for franchise tax purposes. Under the current franchise tax law, a REIT may, in determining its value for franchise tax purposes, deduct the aggregate market value of its investments in the stocks, bonds, debentures, or other securities or evidences of debt of other corporations, partnerships, individuals, municipalities, governmental agencies or governments. Section 3 of the bill draft changes the statute to provide that this deduction may only be used by a REIT that is not a captive REIT.

¹ Under federal and State law, a REIT is taxable only on income that is not distributed to shareholders. The amount of income a REIT distributes is not subject to tax because the REIT is allowed a deduction for the dividends it pays. The amounts received by the shareholders of the REIT are taxable.

² Two common types of captive REITs are rental REITs and mortgage REITs.